



**Testimony**

**of**

**Robert Glauber**

**Chairman and CEO**

**Before the**

**Subcommittee on Capital Markets, Insurance and  
Government Sponsored Enterprises**

**Committee on Financial Services**

**United States House of Representatives**

**Hearing on Self-Regulatory Organizations:  
Exploring the Need for Reform**

**November 17, 2005**

Mr. Chairman and Members of the Subcommittee: NASD would like to thank the committee for the invitation to testify regarding self-regulation in the securities industry. NASD commends the Committee's efforts in beginning this review of the self-regulatory system. As a leading advocate of investor protection and market integrity, NASD welcomes the Committee's focus on possible enhancements to the current regulatory system that could strengthen its operation and efficacy.

## **Executive Summary**

Founded in 1936, NASD is the world's pre-eminent private-sector securities regulator. In 1939, the SEC approved NASD's registration as a national securities association under authority granted by the 1938 Maloney Act Amendments to the Securities Exchange Act of 1934. We regulate every broker-dealer in the United States that conducts a securities business with the public—about 5,200 securities firms that operate more than 108,000 branch offices and employ about 664,000 registered representatives.

Our rules regulate every aspect of the brokerage business. Our market integrity and investor protection responsibilities include compliance examinations, rule writing, enforcement, professional training, licensing and registration, dispute resolution and investor education. NASD examines broker-dealers for compliance with NASD rules, MSRB rules and the federal securities laws, and we discipline those who fail to comply. Last year, NASD filed a record number of new enforcement actions (1,410) and barred or suspended more individuals (830) from the securities industry than in any previous year. NASD has a nationwide staff of more than 2,400 and is overseen by a Board of Governors, more than half of whom are not in the securities industry.

During the last four years, NASD has been in the process of separating from The NASDAQ Stock Market, which is now on an independent course under its own completely separate management and board. NASD still monitors all trading on NASDAQ and will continue to do so pursuant to a regulatory services agreement after NASDAQ becomes an exchange. The separation will be complete after the SEC grants NASDAQ exchange status, which we hope will happen by the end of this year.

The separation of NASD from NASDAQ became necessary when NASDAQ decided to become a for-profit, publicly-traded company. The conflicts from simultaneously running a for-profit market and regulating it were unmanageable and did not best serve investors. Thus, the separation has allowed NASD to realign as a private-sector regulator of the broker-dealer industry and, by contract, of exchanges and markets.

Today, the New York Stock Exchange finds itself in a similar position as it merges with Archipelago and moves toward going public. Whether it should continue operating as a regulator after it begins operating as a for-profit company has been the subject of a great deal of healthy and needed debate in our industry. The concern is that for-profit, publicly traded exchanges will be faced with the conflicting goal of having to maximize profits while not compromising regulation.

Earlier this year, the Securities and Exchange Commission (SEC) published a concept release examining the current self-regulatory organization (SRO) system and seeking public comment on a range of issues. As we told the SEC in our response, one glaring inefficiency in today's regulatory scheme is the dual regulation of firms that are members of both the NYSE and NASD. Currently these 180 firms are faced with dual rulebooks, dual examinations and enforcement, and dual fees.

A solution that makes sense is a partnership between the NYSE and NASD to jointly handle the regulation of the 180 firms that are members of both organizations. Under such a partnership, firms would be regulated according to one rulebook instead of two. They would pay one regulation fee instead of two and, we estimate, would collectively save about \$50 million per year. Firms would have only one examination and enforcement staff to contend with and that would lower their compliance costs also by more than \$50 million a year, by our estimate. These savings could then be passed on to investors, while the regulation of these firms would be more effective and efficient.

Alternating the examination of the jointly regulated firms on an annual basis as some have suggested is not the answer to the problem. An arrangement that calls for each regulator to examine the firms on an alternate yearly basis would result in inconsistent application of the rules. It is just not a workable solution, and investors would be ill-served. It would not answer any of the issues raised by the SEC, specifically conflicts of interests and duplicative regulation.

To best serve investors, any new structure would have to solve the conflict inherent in both regulating and managing a for-profit exchange. It would also have to eliminate the redundancy and inefficiency of having two regulatory groups performing the same functions.

### **Benefits of Self-Regulation**

Self-regulation in the securities industry has a long and effective history. Congress designed the statutory scheme of self-regulation for the securities markets in the 1930s, envisioning that most of the day-to-day responsibilities for market and broker-dealer oversight would be performed by SROs under the SEC's direct oversight. The SEC was charged with supervising SROs and compelling them to act where they failed to provide adequate investor protection. Congress's preference for self-regulation over other forms of regulation was deliberate; Congress recognized that it was impractical for the government to provide the necessary resources to effectively regulate the securities industry. To that end, Congress opted to rely primarily on the resources and expertise of the industry itself, notwithstanding its awareness of the conflicting roles of SROs in the regulatory scheme.

This model of securities regulation has proven effective through nearly 70 years of regulatory experience. Both Congress and the SEC have periodically examined the role of self-regulation in the securities industry, and while each has taken steps in certain

instances to remedy shortcomings, the concept of self-regulation has been repeatedly reaffirmed and strengthened.

The self-regulatory model has many important benefits to investors and the markets. Self-regulation can and does extend past enforcing just legal standards to adopting and enforcing ethical standards (i.e., just and equitable principles of trade). Government regulation is well-suited for policing civil or criminal offenses, but less so for ethical lapses, which, while not necessarily illegal, may be unfair or hinder the functioning of a free and open market. Self-regulation is uniquely capable of protecting investors from those sorts of transgressions.

Private funding is another critical advantage to the self-regulatory model. Millions of dollars can be spent by SROs on examination, enforcement, surveillance and technology at no cost to the U.S. Treasury. In a self-regulatory system, the industry—not the taxpayers—pays for regulation by NASD. Regulators operating in the private sector also are better positioned to move quickly to address regulatory issues because, among other things, they are not subject to many of the spending restrictions of the federal government, and are better able to develop large-scale systems for important regulatory matters like market surveillance, broker registration and trade reporting.

Moreover, private-sector regulators are able to tap industry expertise in ways not readily available to the government and to use this expertise to better protect investors and ensure market integrity. Among other things, this expertise helps to make certain that rules are practical, workable and effective. Also, industry participants often are in the best position to identify potential problems, thus enabling regulators to stay ahead of the curve.

### **Need for Separation of Market and Regulator**

This is not to say that self-regulation is free from conflicts. NASD's evolution into its current corporate structure and separation from NASDAQ illustrates the conflicts that exist when an entity both owns and regulates a market, and how NASD resolved those conflicts.

In the mid-1990s NASD faced a conflict that fundamentally altered its existence. That conflict was whether NASD's corporate structure was appropriate to manage both the regulation of 5,400 firms and their half-million securities professionals, and the operation of a trillion-dollar securities market with its own divergent constituencies.

In November 1994, the NASD Board of Governors appointed an independent committee to review NASD's corporate governance structure and recommend changes that would enable NASD to better meet its regulatory and business obligations, including oversight of The NASDAQ Stock Market. In September 1995, the committee recommended the establishment of two distinct subsidiaries: one to perform NASD's regulatory functions and the other to run NASDAQ. The committee recommended that

each subsidiary have a separate Board of Directors and that NASD remain as the parent corporation overseeing the operations of both subsidiaries.

Based on those recommendations, NASD formed two subsidiaries—NASD Regulation and NASDAQ. And, just as importantly, NASD implemented a new corporate governance structure that ensured a majority of NASD's Board of Governors would be from outside the securities industry. In 2000, NASD created another subsidiary for its mediation and arbitration functions, NASD Dispute Resolution.

In 2000, when NASDAQ decided to become a shareholder-owned, publicly traded exchange, NASD determined that the existing structure that placed regulatory activities in a subsidiary no longer afforded sufficient protection for investors. Operating an exchange to maximize profits for shareholders and simultaneously managing regulatory activities to fully protect investors could not be conducted under the same corporate structure without unmanageable conflicts, in our view. We therefore restructured NASDAQ and NASD as two wholly separate companies with separate managements, separate funding sources and separate, non-overlapping boards. This separation is complete except for the SEC designation of NASDAQ as an exchange and the sale of NASD's remaining minority share ownership in NASDAQ, which we would seek to complete within a year of NASDAQ exchange registration.

Moving forward, NASD has implemented a divisional structure. The first of the three divisions is Regulatory Policy and Oversight, which has primary responsibility for rule-making, member regulation, market surveillance and enforcement. A separate Markets Services and Information Division is responsible for NASD's information and market transparency facilities, including the Alternative Display Facility (ADF), the Trade Reporting and Compliance Engine (TRACE), the Over-the-Counter Bulletin Board (OTCBB) and the Central Registration Depository (CRD), as well as NASD's technology developments and operations. The third division is Dispute Resolution, which is responsible for arbitration and mediation services.

### **SEC Concept Release on Self-Regulation**

Earlier this year, the SEC published a concept release examining the current SRO system and seeking public comment on a range of issues, including: (1) the inherent conflicts of interest between an SRO's regulatory obligations and the interests of its members, its market operations, its listed issuers and, in the case of a demutualized SRO, its shareholders; (2) the costs and inefficiencies of the multiple SRO model; (3) the challenges of surveillance across markets by multiple SROs; and (4) how SROs generate revenue and fund regulatory operations. The SEC also is examining and seeking comment on certain enhancements to the current SRO system and a number of regulatory approaches and legislative initiatives.

The SEC stated that the most controversial aspect of the current SRO system is the inherent conflicts of interest between an SRO's regulatory functions and its members, market operations, listed issuers and shareholders. Conflicts in the dual role of regulating

and serving members can result in poorly targeted and less extensive SRO rulemaking, and weak enforcement of SRO rules. To be effective, an SRO must be structured so that regulatory staff is unencumbered by inappropriate business pressure such as: (a) member domination of SRO funding; (b) member control of SRO governance; and (c) member influence over regulatory and enforcement staff. In addition, the economic influence of some members may create particularly acute conflicts, especially in light of the consolidation of some of the largest securities firms.

### **NASD Response to SEC Concept Release**

NASD firmly believes in preserving a securities industry regulatory model that encompasses self-regulation supervised by the SEC. Self-regulation is a key component of the effective regulation, growth and vitality of the U.S. securities markets, offering a range of benefits that non-industry or government regulation alone cannot replicate.

At the same time, there are inherent conflicts and inefficiencies present in the current regulatory environment. NASD believes that these shortcomings would be best addressed by adopting a form of the “hybrid” models set forth by the SEC in its concept release. Adopting this model would enhance efficiency by eliminating inconsistent member rules, eliminating redundant infrastructure, strengthening intermarket surveillance, and meaningfully reducing the current conflicts in the self-regulatory system.

Accordingly, NASD agrees that a re-examination of the existing self-regulatory system is warranted, but we also strongly believe that the statutory scheme of self-regulation supervised by the SEC should be preserved. NASD believes that the substantial benefits of self-regulation, as illustrated recently by the response to the mutual fund breakpoint issues, continue to greatly outweigh any shortcomings.

### **Benefits of NASD Structure and the Pure Hybrid Model**

In discussing how to enhance the self-regulatory system, the SEC Concept Release focuses on four perceived weaknesses of the existing model: (1) the inherent conflicts of interest between SRO regulatory operations and members, market operations, issuers and shareholders; (2) the costs and inefficiencies of multiple SROs, arising from multiple SRO rulebooks, inspection regimes and staff; (3) the challenges of surveillance of cross-market trading by multiple SROs; and (4) the funding SROs have available for regulatory operations and the way SROs allocate revenue to regulatory operations.

The SEC set forth several alternative versions of what it termed hybrid models, each containing a single member SRO to perform all regulatory activities overseeing firm behavior. Under the first option, the market SROs would maintain all the functions that SROs currently carry out with respect to their market operations, including promulgating market rules, conducting market surveillance and taking enforcement action against rule violators. Alternatively, the market SROs could retain responsibility for promulgating rules and conducting surveillance, but enforcement actions would be referred to the

single member SRO. Under a third option, the market SROs' responsibilities would be limited to market rule promulgation, and the single-member SRO would be responsible for market surveillance and enforcement.

NASD would support any of these hybrid models because they would significantly reduce the costs and redundancies in firm regulation and move to eliminate the conflicts cited earlier that arise when a for-profit, exchange conducts regulatory activities within its corporate structure.

## **Conclusion**

Thank you for giving us the opportunity to testify on this important topic and for your timely review of the securities industry's self regulatory structure. NASD looks forward to working with Congress as it continues to review the changing regulatory landscape.